



the taxes we pay

The Taxes We Pay In Hampton Roads: Where We Are And Recommendations For Change

Taxes and governmental expenditures always are hot topics and nowhere is this truer than in the cities and counties of Hampton Roads. One of the most popular terms du jour is “fiscal imbalance” – the belief that local governmental units are obligated to spend, or need to spend, more dollars than they are able to collect in tax revenue. Consider the following newspaper coverage during the first six months of 2002:

- An article in The Virginian-Pilot argues that the City of Virginia Beach is able to raise revenue to pay for increased spending not by raising property tax rates, but rather by an increase in property tax assessments. An article in the Daily Press suggests Poquoson will follow the same strategy.
- An article in the Richmond Times-Dispatch suggests that Virginians will be paying more for fewer governmental services because of the drop in state revenues.
- Editorials in The Virginian-Pilot support an increase in the user fee for dumping trash in order to reduce the incentive for firms to import trash into Virginia and suggest that the state should help reduce the over-reliance on real estate taxes by local governments.
- An editorial in the Daily Press challenges legislators to take tax reform seriously and to recognize the need for tax revenue increases.
- An article in The Virginian-Pilot suggests an upcoming vote on a sales tax increase is not only a referendum on the building of roads, but also will be a barometer for all public spending.
- An article in The Virginian-Pilot emphasizes that the reduction in the rate of growth in consumer spending, especially in Northern Virginia, reduced the rate of growth in the tax base for sales tax revenue. The article goes on to note that the Hampton Roads area was not impacted as much as was Northern Virginia.
- And, of course, numerous articles have discussed the forthcoming sales tax referenda.

By definition, fiscal imbalance (a situation where expenditures exceed tax revenues) can be cured either by increasing taxes or lowering expenditures. But that does not tell us much, especially where taxes are concerned. First, we need to know where we collect our local tax revenues today and what impact they have on our daily lives. Then, we can utilize that information to evaluate our situation and make some realistic recommendations about possible changes. That is the focus of this chapter.

The Tax Structure In Hampton Roads Today

What are the most important taxes collected by cities and counties in Hampton Roads? Local tax revenue in Hampton Roads is composed of three major parts: (1) property taxes; (2) service charges; and (3) sales and excise taxes. Property tax revenue is further subdivided into taxes on real property, property taxes paid by corporations, personal property tax revenue and property taxes on machinery and tools. Service charges refer to fees levied by government for activities such as waste removal. Sales tax revenue is collected from the 1 percent local-option tax that all Virginia localities impose. Excise taxes include fees paid by consumers for utilities and business licensee taxes, and various smaller taxes such as those charged for motor vehicle licenses, tobacco, and hotel and food. Table 1 presents the proportional sources of tax revenue for cities and counties in Hampton Roads for the 2000-01 fiscal year.

Table 1
WHERE DO CITIES AND COUNTIES IN HAMPTON ROADS
COLLECT THEIR TAX REVENUES?

City/County	Real Property	Pub Serv Corp	Per Prop Gen	Mach & Tools	Service Charges	Sales Tax 1%	Consumer Utility	Business Licenses	Fees on Spec Serv	Other Taxes
Chesapeake	45%	3%	10%	1%	6%	9%	5%	6%	10%	6%
Franklin	32%	1%	8%	0%	10%	13%	8%	5%	13%	10%
Hampton	34%	2%	9%	1%	14%	6%	5%	5%	11%	14%
Newport News	35%	2%	8%	5%	12%	7%	5%	4%	10%	12%
Norfolk	33%	3%	9%	2%	8%	8%	12%	6%	13%	8%
Poquoson	56%	1%	10%	0%	9%	3%	3%	2%	6%	9%
Portsmouth	34%	3%	8%	3%	12%	4%	10%	4%	10%	12%
Suffolk	43%	2%	11%	2%	8%	6%	7%	4%	8%	8%
Virginia Beach	47%	2%	6%	0%	8%	7%	6%	5%	12%	8%
Williamsburg	19%	1%	2%	5%	5%	15%	2%	7%	40%	5%
Gloucester County	45%	2%	12%	0%	10%	6%	3%	3%	7%	10%
Isle of Wight Co	33%	2%	14%	18%	11%	4%	2%	1%	3%	11%
James City Co	48%	2%	12%	6%	6%	8%	0%	4%	8%	6%
Southampton Co	38%	2%	18%	8%	10%	3%	6%	1%	4%	10%
Surry Co	19%	65%	4%	0%	5%	1%	0%	0%	1%	5%
York Co	42%	5%	10%	2%	10%	6%	0%	4%	10%	10%

Source: "Comparative Report of Local Government Revenues and Expenditures for the Fiscal Year Ending 2001," Auditor of Public Accounts, Richmond, Va., March 2002

The city that relies most heavily on the real property tax is Poquoson, followed closely by James City County and Virginia Beach. Of note is the relatively small share of real property tax revenue collected by Norfolk and Portsmouth. There are two reasons for this. First, property values are, in general, lower in these two cities. Second, both cities have a large percentage of tax-exempt real estate. In 1998, approximately 55 percent of Portsmouth land was tax-exempt, while the comparable figure in Norfolk was 48 percent. According to a Hampton Roads Planning District estimate in 2000, about \$20 billion worth of property is not taxed in the Hampton Roads MSA.

Cities such as Norfolk and Portsmouth are not excused from providing services to tax-exempt properties even though those properties do not generate real property taxes. Consequently, these cities must look elsewhere for revenue. Both cities receive a relatively large share of their tax revenue from consumer utility taxes.

Other unusual tax collection relationships also exist in the region. **Isle of Wight County receives a large percentage of its tax revenue from Smithfield Foods, which is collected in the form of a machinery and tools tax. Surry County generates the greatest share of its revenue from public service corporations and this reflects the Surry Nuclear Power Plant.** Williamsburg receives a small share of its revenue from property taxes, but very large shares from both sales taxes (15 percent) and taxes on specific fees. Both are generated primarily from taxes upon hotels and restaurants, and fall substantially on tourists. Elected officials always are anxious to find ways to tax individuals from other cities or jurisdictions, and the farther away, the better. "Tourist taxes," therefore, have always been popular in Hampton Roads.

Virginia Beach and Norfolk also receive relatively large shares of their revenue from taxes on specific services. Like Williamsburg, Virginia Beach receives a sizable share from hotel and restaurant taxes, while Norfolk (which boasts a large downtown financial, entertainment and office district) receives a large share of its tax revenues from restaurants and admission fees.

Of course, one of the things elected officials want to know is how much tax revenue they will collect if their local economies expand. In a report prepared for Virginia Forward, the Barents consulting group offered a methodology to provide that infor-

mation. Table 2 presents Barents' estimates of how responsive tax revenue is to increases in income for a selection of local taxes.

The interpretation of the responsiveness measures is very straightforward. If citizens' incomes increase by 1 percent, then how much will tax revenue increase? Between 1977 and 1989, real property tax revenue increased by 1.05 percent for every 1 percent increase in income; however, between 1990 and 1996, this fell to only 40 percent. **This means that in the 1970s and 1980s, real property tax revenue was growing faster than the economy. Since then, the relationship has changed and property tax revenues have lagged the growth of the economy. This is highly problematic for cities that are highly dependent upon real property tax revenues because the demand for some governmental services may exceed the growth of the economy.** In particular, this can be true in the area of public education, where rising incomes may be associated with rapidly growing school populations and collateral needs to hire teachers and build schools. Of course, citizen demands for public safety, government-sponsored cultural and recreational activities, and infrastructure items such as streets and sewers plausibly can increase just as rapidly. The point is that in recent years the real property tax has shown little promise of being able to keep up with these demands.

In fact, the overall tax picture for cities and counties is increasingly grim. As Table 2 demonstrates, since 1990, local tax revenues have increased only .84 percent for every 1 percent increase in local incomes. Local tax revenues, then, are not keeping up with the economy. This is a message delivered by many mayors and city councils in Hampton Roads. Their *cri de coeur* to state legislators is twofold. Either, they say, allow us to collect a new range of taxes, or redistribute more fully the lucrative taxes that the government of the Commonwealth collects statewide (for example, the state income tax). **Localities in Hampton Roads (and throughout Virginia) feel they are caught in a highly confining box. In general, their tax revenues have not kept up with economic growth. If the rate of income growth is a reasonable measure of the need for additional governmental services, then localities within Hampton Roads fell behind in the 1990s.** Compared to cities and counties, state government was well-heeled financially in the 1990s, and its ability to expand services actually increased faster than state incomes.

Table 2 also reveals that sales tax revenue has grown a bit more slowly than the economy as a whole. The tax revenue source that grew the fastest as the economy grew was the personal property tax.

Virginia has one of the most cyclical income tax bases in the country because a 1 percent decline in state incomes will lead to a 1.7 percent decline in the income tax collections. This finding, in Randall Holcombe and Russell Sobel's 1997 book, "Growth and Variability in State Tax Revenue: An Anatomy of State Fiscal Crises," suggests that the fiscal pressure imposed on the state government from an economic downturn is greater in Virginia than in most other states. Only California, Oregon, Hawaii and Wisconsin have more unstable income tax bases than Virginia. The truth is that overall income tax collections in Virginia are highly dependent upon the prosperity of Northern Virginia. When that region was booming (as in the 1990s), state income tax and capital gains tax collections skyrocketed. However, the economic slowdown that began in 2000, plus the problems associated with the information technology industry in general and dot.com firms in particular, caused state tax revenues to fall far short of estimates.

It is interesting to note that researchers estimate that the sales tax base in Virginia has about average stability. That is, sales tax revenues are a more stable source of funds for government than is the income tax. **Thus, while nearly all elected officials in cities and counties argue in favor of an increased distribution of state income tax revenues back to these localities, if implemented, this would increase the variability of local tax revenues.** Cities and counties likely would have more tax money to spend over the years, but that revenue source would become less reliable, and perhaps less predictable, in amount.

Table 2
THE RESPONSIVENESS OF CITY AND COUNTY
TAXES TO INCREASES IN INCOME

Local or County Tax	Responsiveness of Tax Collections to a 1 Percent Increase in Income
Real Property: 1977-1989	1.05%
Real Property: 1990-1996	0.40%
Personal Property: 1977-1996	1.40%
Sales: 1977-1996	0.96%
Other Local: 1977-1996	0.90%
All Local Taxes: 1977-1996	1.15%
All Local Taxes: 1990-1996	0.84%

Source: Barents, "Virginia's State and Local Tax Structure: Recent Performance and Restructuring Options," Washington, D.C., December 1999, 34.

Evaluating The Taxes We Pay In Hampton Roads

REAL PROPERTY TAXES

Tax revenue on real property is derived from taxes on land and from improvements to land. Taxes imposed on land are relatively efficient because there is little one can do to avoid paying the taxes. Land can't be moved, though it can be rendered inactive. But, who ultimately bears the burden of property taxes – landlords or renters? The answer depends upon a variety of factors, although available evidence suggests that landlords successfully pass on to renters most property taxes.

The Barents study cited previously found that since 1990 property tax revenue has not risen proportionately with personal income. If we assume that increased income is highly correlated with increased demands for public services, then the share of tax revenue from real property for the financing of government spending has fallen even as the economy has grown. Against this, Virginia currently attempts to assess real estate at 100 percent of its market value. Thus, rapidly rising real estate prices may stimulate property tax revenues.

Because property tax revenue is the greatest local revenue source for most municipalities, the pattern of property tax revenue over time is quite important. Graph 1 shows the growth in property tax revenue realized by the larger cities in Hampton Roads since 1981. The data are adjusted for inflation and thus represent “real” magnitudes, such that tax revenue in the year 2000 has the same purchasing power as tax revenue in 1981.

The data indicate steady growth for Virginia Beach and an upsurge in the growth rate for Chesapeake in the early 1990s. The cities of Hampton and Newport News have shown modest increases. Property tax incomes have been relatively constant for the City of Portsmouth. During the early 1990s, Norfolk's real property tax revenue actually began to decline, underlining that city's oft-expressed revenue plight.

TAXES ON PUBLIC SERVICE CORPORATIONS

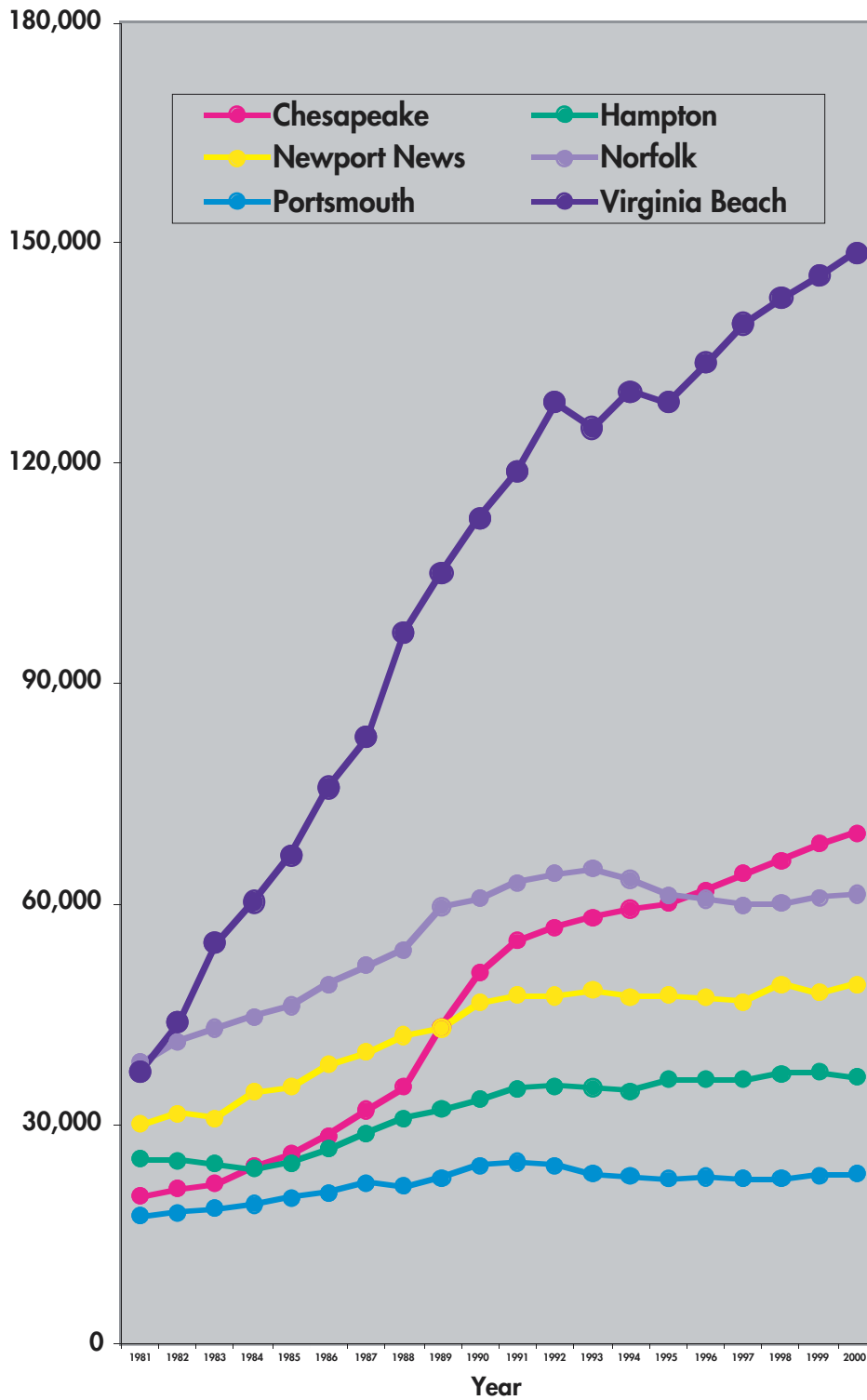
Taxes on public service corporations fall primarily on public utilities and large corporations. Table 1 demonstrates that, except for Surry County, the cities and counties of Hampton Roads earn from 1 percent to 5 percent of their tax revenue from such taxes. In the case of Surry, the taxes it imposes on the nuclear power plant generate an astonishing 65 percent of its tax revenue.

Further, the data suggest that the machinery and tools tax is an important income source for Isle of Wight and Southampton counties. Barents computed the effective tax rate per \$100 of assessed property for the category Real Property and Machinery and Tools, and found that tax rates in Hampton Roads as a whole are less than the national average, though Norfolk and Virginia Beach are somewhat above the average. This makes these two cities less attractive as business locations, according to Barents.

The taxation of corporate property always has been a factor in determining where firms locate. This has caused many local governments to offer reduced taxes to firms that open new locations in their cities or counties. There are two major problems with this. First, a competitive “prisoner's dilemma” situation may arise in which competing localities offer tax breaks that cancel each other out, but impoverish each city or county because of the resulting reduced tax revenue. If all localities ceased to offer such inducements, they probably would attract the same firms, and save a great deal of tax money at the same time.

A second problem is that reductions in taxes upon corporations may of necessity lead to increased property taxes for individuals. Unless a city or county is experiencing significant growth in its tax receipts, any tax concessions that it offers one firm or individual must be offset by tax increases it imposes on others.

Graph 1
ANNUAL REVENUE FROM THE REAL PROPERTY TAX IN
HAMPTON ROADS CITIES AND COUNTIES
(Real Property Tax Revenue 1982-1984 = 100)



Source: "Hampton Roads Data Book," June 2001

PERSONAL PROPERTY TAXES

The infamous “car tax” dominates this category, primarily because automobiles are substantial assets and easily tracked. The recent reductions in the car tax affect city and county tax revenues, as these revenues previously were captured by localities. Now, the Commonwealth has to make up the difference (which it has done imperfectly).

Other personal property includes the assets of businesses that are not listed as public service corporations and other personal property such as motorcycles and mobile homes.

Car tax rates in Hampton Roads average 4.05 percent of the fair market value of automobiles, which is higher than the Virginia average of 3.41 percent.

SALES TAXES

A sales tax is paid as a fixed proportion of the price of a taxable good or service. In Virginia, cities and counties may assess a 1 percent local sales tax, and nearly all do. The tax in Virginia, as in most other states, was offered to localities to reduce their dependence on property tax revenue, as well as make the sales tax more palatable.

Easily, the most critical sales tax issue revolves around the definition of the tax base. As discussed earlier, Virginia has one of the most narrow sales tax bases in the country. According to The Virginian-Pilot, almost 400 separate economic activities and organizations are excluded from sales taxation. The Virginia Department of Taxation estimated that in 1998 the combined exemptions to the sales and use tax created an annual loss of approximately \$3.6 billion in tax revenue. This would have yielded approximately \$800 million in increased income to local governments from the 1 percent option. Barents cites a study by the Federation of Tax Administrators that found that Virginia taxes only 16 of the 164 items commonly included in the base of a sales tax. The Commonwealth could solve most of its current tax revenue problems simply by widening the base of its sales tax. Rates could stay the same, or even be reduced.

UTILITY TAXES

Taxes on utilities constitute relatively large sources of revenue in Norfolk, Portsmouth and Franklin. Such taxes tend to be popular because the utilities are an attractive political target, and when taxed, are not likely to stop serving the cities that tax them. This reflects the fact that virtually every dollar of these taxes is passed on to consumers. Thus, most cities and counties tax the purchase of items such as natural gas, coal, mobile telephones and water. Nevertheless, the deregulation of electricity (and the movement toward freer markets in that area) may provide some consumers with the means to find substitutes for the electricity provided by their hitherto monopolistic electricity supplier. If so, then cities and counties will have to become much more careful with such taxes. An increase in electricity taxes actually could reduce tax revenue if consumers actively switch their patronage to alternate suppliers.

EXCISE TAXES (SPECIAL SALES TAXES)

Excise taxes are sales taxes on specific products. The firms that provide the taxed products pay these taxes, and their ability to shift the burden of the tax to the consumers is primarily a function of the substitutes available for consumers. Table 3 presents 2001 data for selected Hampton Roads municipalities regarding three such taxes: meals, cigarettes and lodging.

These excise taxes do not vary significantly across these municipalities. However, the relative differences are important because even minor differences can cause consumers to alter their consumption patterns – for example, by purchasing their gasoline in one city rather than another, or scheduling a meeting in one county rather than another. The data suggest that,

Table 3
EXCISE TAXES IN HAMPTON ROADS CITIES AND COUNTIES

City/County	Meal Tax Rate	Cigarette Tax, \$ Per Pack	Lodging Tax Rate
Chesapeake	5.5%	\$.3125	6.0%
Hampton	5.5%	\$.44	5.5%
Newport News	5.5%	\$.4375	5.5%
Norfolk	5.5%	\$.375	8.0%
Portsmouth	6.5%	\$.44	6.5%
Suffolk	5.0%	\$.30	5.0%
Virginia Beach	4.5%	\$.27	5.5%
Williamsburg	5.0%	Doesn't Have	5.0%
James City Co	4.0%	Doesn't Have	4.0%

Source: Weldon Cooper Center for Public Service, University of Virginia, “2001 Tax Rates: Virginia’s Cities, Counties, and Selected Towns,” Charlottesville, Va., 2001

holding everything else constant, it is cheaper to stay in Virginia Beach than in Norfolk, that hamburgers will be more expensive in Portsmouth than James City County, and that cigarettes will be cheaper in Chesapeake than Newport News.

Making Some Comparisons

In this section, we compare the tax systems of different governmental units. We begin by comparing the cities and counties of Hampton Roads with counterparts in other regions. Then, we will examine the tax circumstances of the Commonwealth of Virginia vis-à-vis other states, because **the Dillon Rule makes cities and counties absolutely dependent upon state rules and regulations.** Cities and counties either can pay for services themselves, or they can rely upon state government to provide the funding for those services. Depending upon the state in question, public education and local roads receive either substantial or very little state financial assistance. It is important to keep this in mind in an examination of city and county tax levels. **Low local taxes may mean high state taxes, and vice versa. To paraphrase the muffler commercial, “You can pay me here, or you can pay me there.” That is, if we don’t pay for education locally, likely we will pay for it at the state level. Thus, only when we examine the sum of local taxes and state taxes can we make valid comparisons between and among cities, counties and states.**

Table 4 presents data on per capita local tax payments made in a select group of cities. These data are quite striking. **It is readily evident that the local tax burdens of Virginians tend to be higher – often much higher – than those of citizens residing in other states.** Clearly, there are other U.S. cities that have much higher tax burdens than those in Virginia. Among them are New York, Boston, Washington, D.C., and San Francisco. Nevertheless, the average annual local tax paid by a citizen, say, in Richmond, is well more than double that paid by residents of Greensboro, Charlotte, Jacksonville, Louisville, Atlanta, Pittsburgh and Knoxville. **Richmond’s local tax burden is 36 percent more than Baltimore’s. And, while Richmond is the outlier within Hampton Roads and vicinity, every city in Hampton Roads imposes a higher tax burden on its citizens than any other city in the sample, with Baltimore being the single exception.**

What difference does this make? First, over the long pull, both individuals and businesses pay attention to relative tax levels when they make locational decisions. We know this well in Hampton Roads because of the large number of military personnel and military retirees who reside here. These individuals must weigh residence in Hampton Roads and Virginia against alternatives such as low-tax Jacksonville where, in addition, there is no state income tax.

Second, **ultimately there is a relationship (though not perfect) between tax levels and economic growth.** The last column of Table 4 records the annual percentage of growth in jobs for the various cities. Charlotte leads the pack with a 4.7 percent growth rate, while in Virginia only Virginia Beach is as high as 1 percent. Clearly, there is a negative relationship between tax burdens and job growth. Graph 2 plots the data for each city with respect to local tax burden and job growth. While hardly perfect, there is little doubt that moderate to low local tax burdens are associated with increased economic growth. Of course, economic growth is a function of many different influences, some of which are controllable (taxes, transportation, education) and some of which are not (climate). Tax burdens, however, do make a difference and Graph 2 demonstrates this. The lesson is that it is seldom a good idea for a city or county to be an outlier on any tax, or on its tax burden as a whole. Individuals and firms react adversely to taxes that are much higher than the ordinary. **High local taxes may mean lower state taxes, and vice versa. Nonetheless, “Do thou likewise” is a good rule for local elected officials to follow with respect to tax rates. Cities and counties that violate this rule and call adverse attention to themselves usually pay for it as the years pass. Balance in the local-state tax relationship is ordinarily an excellent path to follow.** If either party (local government or the state) has exceptionally high levels of taxation, this is likely to alter what is produced and where it is produced.

Table 4
COMPARING TAXES PAID PER CAPITA IN HAMPTON ROADS CITIES
WITH OTHER CITIES IN THE UNITED STATES

City or Metropolitan Statistical Area (MSA)	Annual Local Gov't. Taxes Paid Per Capita	Tax Rank Within the United States*	Per Capita Income	Local Taxes as a Percent of Per Capita Income	Annual Percent Growth in Jobs
Norfolk, VA	\$1,042	22	\$21,659	4.81%	0.4%
Newport News, VA	978	25	21,610	4.53%	0.2%
Virginia Beach, VA	1,015	23	27,271	3.72%	1.0%
Portsmouth, VA	857	31	20,144	4.25%	0.6%
Hampton, VA	902	28	21,210	4.25%	0.3%
Hampton Roads	1,007	N/A	24,184	4.14%	N/A
Chesapeake, VA	1,130	18	23,458	4.82%	0.4%
Richmond, VA, MSA	1,447	7	28,714	5.04%	2.0%
Greensboro, NC	448	112	26,130	1.71%	2.1%
Charlotte, NC, MSA	418	123	29,291	1.43%	4.7%
Jacksonville, FL, MSA	551	76	26,373	2.09%	3.0%
Louisville, KY, MSA	659	52	26,628	2.47%	1.3%
Baltimore, MD	1,062	21	29,953	3.55%	1.5%
Atlanta, GA	601	64	31,354	1.92%	2.7%
Pittsburgh, PA	717	36	29,069	2.47%	-0.3%
Knoxville, TN	583	68	25,340	2.30%	-0.4%

*Rank is computed for approximately 190 cities with populations greater than 100,000 in 2000.

Sources: "City/County Data Book 2000," "The State and Metropolitan Data Book:1997-1998" and "The Hampton Roads Data Book." The data are for 1996-97. Hampton Roads local tax computed as a population-weighted average of the cities. Data availability forced the use of metropolitan area data in several cases.

Table 5
PROPERTY, SALES AND INCOME TAXES
IN VIRGINIA AND SELECTED STATES (PER CAPITA)

State	Property Tax Per Capita	Rank Among States	Sales Tax Per Capita	Rank Among States	Income Tax Per Capita	Rank Among States	Combined Taxes Per Capita	Rank Among States
Virginia	726.14	27	388.06	45	644.39	16	1,758.89	27
North Carolina	472.18	41	526.33	34	673.09	12	1,671.60	30
Florida	820.34	19	818.40	7	0.0	46	1,638.74	31
Kentucky	363.25	46	459.33	41	656.97	14	1,479.55	39
Maryland	748.31	23	394.38	44	1,042.86	4	2,185.55	11
Georgia	651.86	33	727.43	13	577.19	22	1,956.48	20
Pennsylvania	720.72	28	481.23	39	608.86	18	1,810.81	25

Source: Barents, "Virginia's State and Local Tax Structure: Recent Performance and Restructuring Options, 1999," 9-12. The data are for 1996.

What about state tax burdens? Table 5 presents data that combine local property taxes with state sales and income taxes. One can see that Virginia's property tax revenues per capita rank it in the middle of the 50 states. Its sales tax revenues per capita are among the lowest in the nation (45th). The Commonwealth's income tax collections per capita are higher than average, and here Virginia ranks 16th.

When we put all of this information together and combine local tax payments with state tax payments, we find Virginia to be in the middle of the pack, ranking 27th overall in taxes paid per capita. Thus, Virginia is neither a high-tax nor a low-tax state in a national context. Tax burdens in Virginia are lower than those in neighboring Maryland, which must be classified as a high-tax state, but are a bit higher (overall) than those in North Carolina.

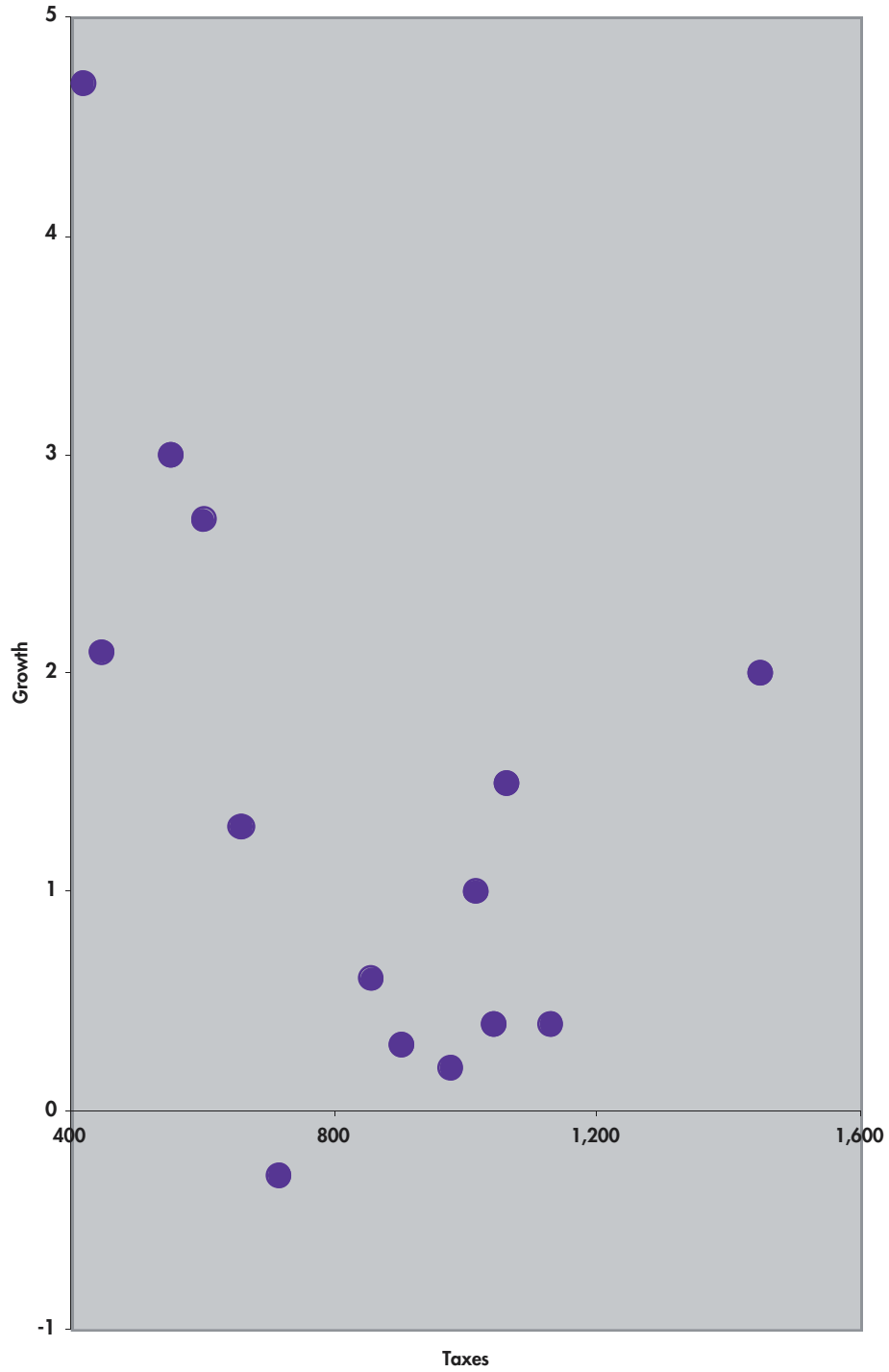
Table 6
TAX PROGRESSIVITY AND REGRESSIVITY
IN VIRGINIA AND OTHER STATES

State/Tax	Sales Taxes			Property Taxes			Income Taxes			All Taxes		
	Low	Mid	Top	Low	Mid	Top	Low	Mid	Top	Low	Mid	Top
Virginia	5.2%	3.2%	1.8%	2.8%	2.1%	2.4%	1.7%	3.4%	4.1%	9.6%	8.7%	8.3%
North Carolina	6.5	4.0	2.6	2.1	1.4	1.6	1.1	3.9	4.9	9.6	9.1	7.7
Florida	8.2	5.1	3.1	5.7	2.5	2.7	0.0	0.0	0.0	14.0	7.7	5.8
Kentucky	6.1	3.9	2.5	2.2	1.4	1.9	2.1	5.1	5.7	10.4	10.2	8.7
Maryland	4.6	2.7	1.6	3.2	3.0	3.2	3.2	5.4	5.7	10.8	9.8	8.2
Georgia	7.3	4.3	2.6	2.8	1.8	2.1	1.0	3.5	4.0	11.1	9.6	7.4
Pennsylvania	5.2	3.2	2.0	5.6	3.4	3.5	2.6	3.6	3.7	13.3	10.2	9.2

Note: Each percentage in the table represents the proportion of an individual's income that he/she pays in taxes. Thus, a Virginian in the lowest quintile of incomes (the lowest 20 percent) pays an average effective sales tax rate of 5.2 percent of his/her income. For the highest 20 percent of Virginia incomes, however, the effective sales tax rate falls to only 1.8 percent.

Source: International Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States." Washington, D.C., data are for 1995.

Graph 2
THE RELATIONSHIP BETWEEN ANNUAL JOB GROWTH
AND ANNUAL TAXES PAID IN CITIES



Source: Data taken from Table 5

Many people believe one of the most important characteristics of any tax system is its progressivity. That is, they want higher-income individuals to pay a larger proportion of any tax than lower-income individuals. Table 6 presents such data for those with the lowest 20 percent of incomes, the middle 20 percent of incomes and the highest 20 percent of incomes (“low,” “mid,” “top”). The data are for 1995 and reflect non-elderly married couples.

One can see in Table 6 that Virginia’s tax system is not progressive; this is especially true for the sales tax, where the top 20 percent of incomes pay an average of only 1.8 percent of their incomes in sales taxes. **Thus, the sales tax in Virginia is a regressive tax because lower-income individuals pay a higher proportion of this tax than do higher-income individuals.** Virginia’s property tax and its income taxes are roughly proportional – neither progressive nor regressive. Taking all of these taxes together, **the overall Virginia tax structure is mildly regressive.** Still, this is also true in all of the other states in the sample, except for Florida, which supports a much more regressive tax structure than the other states. This reflects the fact that Florida does not have a state income tax.

Table 7
GENERAL SALES AND EXCISE TAX RATES
IN VIRGINIA AND OTHER STATES

State	Sales Rate Tax	Gasoline Tax, cents per gallon	Cigarette Tax, cents per pack	Beer Tax, cents per gallon
Virginia	3.5%	\$.175	\$.025	\$.256
North Carolina	4%	\$.243	\$.050	\$.484- \$.534*
Florida	6%	\$.040	\$.339	\$.480
Kentucky	6%	\$.150	\$.030	\$.080
Maryland	5%	\$.235	\$.660	\$.090
Georgia	4%	\$.075	\$.120	\$.480
Pennsylvania	6%	\$.120	\$.310	\$.080

*North Carolina beer tax varies with container size.

Source: The Tax Foundation, “Various State Tax Rates as of December 21, 2001,” <http://www.taxfoundation.org/variousrates.html>

Whether one believes a progressive tax system is equitable is a matter of opinion. What is true, however, is that progressive tax structures tend to generate more tax revenue than regressive tax structures.

Since sales and excise taxes are so important a part of the Virginia tax structure, it is worthwhile to examine how the Commonwealth compares to other states in this area. Table 7 compares Virginia’s tax rates on general sales, gasoline, cigarettes and beer to the rates charged by other states. This comparison is useful because it highlights the willingness of elected officials to tax specific products that are, in general, relatively unresponsive to price changes (at least in the short run) and have the potential of generating substantial tax revenue. Further, many argue that such taxes are a good idea because several constitute “sin” taxes upon behaviors that should be discouraged.

The data reflect a mixed picture for Virginia where sales and excise taxes are concerned. The Commonwealth’s sales tax rate is the lowest among the states in the sample; its gasoline tax is fourth highest among the seven states; its cigarette tax is the lowest among the seven; and its beer tax is fourth highest. In fact, Virginia’s cigarette tax is the lowest in the United States! Clearly, there is room (though probably not the political will) for the Commonwealth to increase this tax.

The November 2002 regional sales tax referenda in Hampton Roads and Northern Virginia will provoke many questions about the existing level of sales taxes and overall tax burdens in the Commonwealth. **As Table 7 demonstrates, Virginia’s sales tax is low compared to other states.**

Table 8
GROWTH IN PERSONAL INCOME
VERSUS GROWTH IN STATE TAXES, 1990-2000

State	Percent Real Growth in Taxes	Rank of State Tax Growth	Percent Real Growth in Personal Income	Percent Growth in Personal Income Minus Growth in Taxes
Virginia	4.51%	17	3.06%	-1.45%
North Carolina	4.61%	13	3.85%	-.76%
Florida	4.24%	20	3.12%	-1.12%
Kentucky	3.89%	27	3.00%	-.89%
Maryland	2.67%	43	2.43%	-.24%
Georgia	4.47%	18	4.49%	+.02%
Pennsylvania	3.26%	35	2.96%	-1.30%

Note: The growth rates are "real," that is, they are corrected for inflation and all dollars are year 2000 dollars.

Source: The Tax Foundation, "Table 3: State Tax Growth Compared to Personal Income Growth, 1990-2000

" <http://www.taxfoundation.org/tgaxgrowth.html>

A final useful comparison deals with the relationship between state tax growth and growth in personal income during the 1990s. Table 8 presents the evidence.

The first column provides information on the average annual growth in taxes over the decade. North Carolina and Virginia lead the pack in this sample of states. Both relied upon dramatic increases in tax collections to increase public spending significantly in the 1990s. The third column records the growth rate of personal income over the decade of the 1990s. Here, Georgia clearly leads the way. Virginia's 3.06 percent annual rate of growth in personal income over the decade of the 1990s slightly exceeded the national average (2.95 percent) and ranked 20th among the 50 states. Reflected in the last column is the difference between the growth in income and the growth in taxes. **Virginia does not look good in this light, for its growth rate of taxes exceeded the growth rate of its income by 1.45 percent, the largest deficit in the sample.** Virginia is neither a low-tax nor a high-tax state in a national context. However, trends such as the one identified in Table 8 bid to reverse that status. **While many commentators and elected officials have been effusive in their praise of the 1990s in terms of the Virginia economy, in fact the performance of this economy was only slightly better than average during the decade.** Further, one might well argue that the Commonwealth lost its fiscal discipline during the 1990s, one of the reasons why Gov. Mark Warner and the General Assembly have been grappling with an annual budget deficit that appears to grow continuously.

Suggestions For Change

In this section we discuss proposed modifications to the existing tax structure to help address the revenue concerns of local governments. The most attractive set of proposals was put forward by the State Commission on Local Tax Structure in 2001. The recommendations relevant to tax policy, as opposed to spending policy or the shifting of spending responsibility to the state, were:

- Remit no less than 6 percent of state income tax revenue to localities based on a yet-to-be-developed funding formula.
- Expand the sales tax to services, amusements and auto repair.
- Simplify the state income tax to two brackets: 5 percent on taxable income up to \$50,000 and 5.75 percent on taxable income greater than \$50,000.
- Give cities and counties identical taxing authority.
- Examine the granting of tax-exempt status to non-governmental real properties.

Proposals to remit increasing amounts of the state income tax to localities have long been a popular notion with cities and counties. **Proponents point out that the Commonwealth is very good at collecting income taxes. The state income tax is an efficient, highly productive tax in terms of revenue generation, while the major revenue sources of the localities (such as the real property tax) are much less efficient and are not expanding as fast as the economy as a whole.** Nearly everyone agrees on these points. The problem, of course, is how to distribute the money to the localities. No locality wants to receive a smaller slice of the pie than it is receiving now. Some suggested formulae actually have been shown to diminish the amount of revenue that regions such as Northern Virginia and Hampton Roads currently receive from the state. It would be difficult to make all localities “winners” if a new distribution formula were adopted, unless taxes were increased at the same time. That does not seem likely. For that reason, it is not clear that this recommendation will ever be politically feasible, despite its overall appeal.

Expansion of the sales tax base may be the least problematic of available policy options in terms of political impact. The growing use of services and the accompanying proportionate reduction in the consumption of physical goods have meant that the Virginia sales tax no longer covers a large proportion of economic activity. As The Virginian-Pilot noted acerbically, Virginia taxes coffins, but not funerals. Consequently, many experts believe that more items should be subject to the sales tax, especially services. If this is accomplished, then it will reduce the current tax preference that exists for untaxed services.

If and when the sales tax is made more universal, in theory it would be possible to lower the sales tax rate without reducing revenue. This may seem an unlikely outcome, but one that has occurred in other states. In any case, an increase in the sales tax base would increase the tax revenues of localities because the localities receive 1 percent of the revenue generated from a now much wider sales tax base.

There are other sales tax options to consider. Some individuals have suggested that the current 3 percent motor vehicle sales tax be replaced by the 3.5 percent general sales tax. This could generate an additional \$100 million in state tax revenue and might generate less pain than many other revenue options.

Economists nearly always favor simple, straightforward, broad-based taxes with low marginal rates. This reduces economic distortions and also diminishes the financial and personnel resources individuals and firms must devote to filing taxes under a more complicated set of tax rules. The local impact of this, however, would be difficult to predict because of both economic and political factors. However, rather than tax simplification in the Commonwealth, much the opposite has taken place in recent years. **During the 1990s, at least \$1 billion in tax preferences were approved by the General Assembly.** Most of these preferences have surface virtue – for example, reducing the taxes of senior citizens – but they complicate the tax code, introduce distortions, impose additional costs on other individuals who must now pay more, and reduce government expenditures on other vital items such as transportation and education. It is not clear that such well-meaning actions are good public policy.

Currently, not all cities and counties in Virginia have the ability to levy taxes. It makes economic sense to treat cities and counties the same with regard to their ability to impose taxes. They both offer the same services. Further, there is little overlap between city and county governments in Virginia, and hence there are no double taxation issues that would appear to preclude treating cities and counties the same.

Finally, as noted before, **the exclusion of many properties from taxation clearly injures cities such as Newport News, Norfolk and Portsmouth. These cities have the most tax-exempt property of any governmental units in the region. Arguably, the Commonwealth should treat these cities, which have substantial tax-exempt property in their midst, in a fashion similar to the way it treats the City of Richmond.** Richmond receives significant funding from the Commonwealth because it is unable to tax the considerable amount of state property located within its city limits. The same general argument can be made in favor of “offset funding” for Hampton Roads, most especially because of the tax-exempt state port facilities in the region. At the same time, it should be noted that the Commission on Local Tax Structure, in its report, made the argument that many localities have not imposed service fees that could be charged on tax-exempt property. Within limits, this approach might allow Newport News, Norfolk and Portsmouth to recoup some of their lost revenues. These cities would have to be careful, however, that their service fees do not cause shipping firms and port traffic to move elsewhere.

Final Observations

The most important role that economists play in a discussion of taxes and tax policy is to provide citizens and political decision-makers with a set of the relevant issues and a prediction of what the impact changes in tax policy will be. The final decision is often based on political rather than economic criteria. Nonetheless, a final example is useful. **Consider the looming possibility of an increase in the general sales tax within the Hampton Roads region in order to pay for vital transportation projects. Is this the best way to generate the needed revenue? Most economists would say “no,” and would instead support a user tax on gasoline.** This is viewed as preferable to a general sales tax increase, which would force some individuals who do not use the new highways and bridge/tunnel crossings to pay for them nonetheless. The Virginia sales tax also is notably regressive, and lower-income individuals pay a much higher proportion of their incomes in sales taxes than do higher-income individuals.

Yet another option, in lieu of an increase in the general sales tax, would be to borrow the necessary funds in the bond market and then to pay for the bonds with tolls imposed on drivers who use the new highways and bridge/tunnel. Tolls have been notably unpopular in Hampton Roads because they constantly remind drivers of the cost of road projects (many drivers would prefer the illusion that their driving is “free”) and because drivers frankly object to the hassle associated with toll booths.

We cannot settle this issue here. Nonetheless, as we have done with the overall tax structure of the region, we can use rational analysis to point out the characteristics of the alternatives in front of us. In the final analysis, as a wag once pointed out, most citizens believe that the best tax is one that they pay less and others pay more – a simplistic formulation, but remarkably accurate.